This memorandum is in response to your request for assistance. The advice rendered is conditioned on the accuracy of the facts provided. Please contact the undersigned if any part of the stated facts is inaccurate as the legal conclusion may be affected.

ISSUES

1. Whether (“Taxpayer”) has filed procedurally valid protective claims and/or refund claims prior to the expiration of the period for filing refund claims for the tax years through (“claim years at issue”) for which Taxpayer is claiming a Foreign Tax Credit (“FTC”) pursuant to perfecting the protective claims.¹

2. Whether Taxpayer has exhausted all effective and practical remedies to reduce its foreign tax liability and is therefore entitled to FTC for taxes paid on a constructive dividend, representing the difference between the interest rate charged on a loan to (“USSub”) from its indirectly-owned controlled foreign corporation, (“CFC2”) and the arms-length interest rate determined by the (“Foreign Tax Agency”), if it initially sought Competent Authority (“CA”) relief for the tax years through (“tax years at issue”) but later

¹ Taxpayer resolved the issue with the Foreign Tax Agency through tax year . Taxpayer elected to claim deductions, rather than foreign tax credits, for foreign taxes paid with respect to post - tax years. No refund was claimed for the tax year.
rejected the CA proposal, instead pursuing remedies in the Swiss ("Foreign") court system, and eventually reaching a resolution with the Foreign Tax Agency.

CONCLUSIONS

1. The protective claims filed by Taxpayer, in which it preserved its right to file refund requests based upon FTCs claimed for each of the claim years at issue, contingent upon the final determination with respect to the amount of withholding tax on a constructive dividend, are procedurally valid protective claims in that such claims contain sufficient information to apprise the Service of the grounds upon which Taxpayer is claiming the credit subject to the resolution of the contingency. Additionally, the protective claims for the claim years at issue were timely filed prior to six months before the expiration of the duly executed extended statutory periods of limitation for each of the respective years.

2. Taxpayer’s litigation of the Foreign tax dispute through the Foreign Supreme Court exhausted its Foreign law remedies with respect to the interest rate charged on the loan from CFC2 to USSub, but not with respect to the applicable withholding tax rate, which the Foreign courts did not address. Taxpayer’s subsequent acceptance of a higher interest rate than that affirmed by the Foreign courts, in connection with a favorable settlement of the withholding tax rate issue with the Foreign Tax Agency, should be evaluated based on an assessment of the hazards under Foreign law with respect to the availability of the treaty rate. Taxpayer’s rejection of the CA proposed settlement does not constitute a failure to exhaust its effective and practical remedies under the treaty, if it reasonably believed based on competent Foreign law advice that it could further reduce USSub’s and CFC2’s Foreign tax liability by litigating in the Foreign courts. However, correlative adjustments to the U.S. withholding tax liability of CFC2 are not properly considered a cost of minimizing either USSub’s or CFC2’s Foreign tax liability.

FACTS

CFC2 is a wholly-owned Foreign subsidiary of ("CFC1"), which is a wholly-owned foreign subsidiary of USSub. Prior to , CFC1 operated as an international marketing vehicle and was responsible for purchasing products manufactured by USSub and selling them to unrelated foreign distributors. CFC2 served as the finance subsidiary for the global group. In , Taxpayer and the IRS settled a transfer pricing controversy with respect to sales by USSub to CFC1 for tax years . Under the settlement, USSub established an account receivable and CFC1 an account payable in the amount of the agreed transfer pricing adjustment. USSub then contributed to CFC1 the accounts receivable, which were then cancelled. The Foreign Tax Agency had informed CFC1 that repatriation of the adjustment amount due from CFC1 to USSub would be treated as a dividend subject to withholding tax, but a loan of equal amount would not be treated as a taxable dividend repatriation. In
addition, if instead of lending funds directly to USSub, CFC1 loaned funds to CFC2 and CFC2 loaned funds to USSub, so that CFC1 would not receive interest income directly from USSub, dividends later paid by CFC1 to USSub would receive the benefit of a withholding rate of percent, rather than the standard rate of percent, pursuant to the Convention Between the United States of America and for the Avoidance of Double Taxation with Respect to Taxes on Income (“Treaty”).

Pursuant to the terms of an agreement between the Foreign Tax Agency and the Taxpayer group (“Agreement”), CFC1 lent $ to CFC2, which CFC2 then lent to USSub. Because the loan was payable on demand, the variable interest rate was set equal to the applicable federal rate (“AFR”) for comparable short-term loans. During the period through , USSub accrued total interest expense due to CFC2 of $ , which Taxpayer deducted from its U.S. income tax returns for the same period, and included a corresponding amount on its returns as U.S. source subpart F income of CFC2. See IRC Section 904(h)(1)(A)(i). USSub withheld U.S. tax at the 5 percent treaty rate on the U.S. source interest payments made at the short-term rate to CFC2.

In , during an audit of CFC2, the Foreign Tax Agency determined that the interest rate on the loan from CFC2 to USSub was not arms-length; rather, the Foreign Tax Agency determined that the proper rate would be the interest rate applicable to long-term industrial obligations. Its decision was based on the length of time the loan was outstanding (more than one year) and the fact that the loan was granted in the context of industrial enterprise. The Foreign Tax Agency determined that the underpayment of interest resulted in a constructive dividend from CFC2 to USSub subject to a percent withholding rate, finding the more favorable percent rate applicable only in cases in which the shareholder receiving the dividend holds at least a minority participation directly in the distributing Foreign company.

CFC2 contested the adjustment proposed by the Foreign Tax Agency, and along with Taxpayer, proposed that the parties use a percent interest rate for all the tax years at issue. The Foreign Tax Agency ultimately rejected the proposals and applied the interest rates associated with long-term U.S. bonds to the tax years at issue; such rates ranged from a low of percent to a high of percent.

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2 Under of the Treaty, dividends paid by a Foreign subsidiary to its U.S. parent may be subject to a percent withholding rate (as opposed to percent) if not more than percent of the gross income of the paying corporation is derived from interest and dividends, other than interest and dividends received from the payer’s own subsidiary. Although a Foreign company that receives interest income subject to the beneficial percent Treaty rate must distribute at least percent of that income annually, the Foreign Tax Agency agreed to suspend the distribution requirement for five years if CFC1 agreed to continue to do business in for that period.

3 Taxpayer claims that, based on this agreement with the Foreign Tax Agency, it understood that going forward, the rate of withholding would be percent on all dividends distributed to Taxpayer.

4 The interest rates on the loan during the tax years at issue ranged from a low of percent to a high of percent.

5 The Foreign Tax Agency also noted that, during the same period of time, CFC1 was granted U.S. loans on which interest was due at the rate of and percent.
the Foreign Tax Agency submitted its decision to CFC2, finding constructive dividends in the amount of , upon which it assessed a percent withholding tax, totaling , for the tax years at issue. CFC2 appealed this decision with the Foreign Tax Agency, asserting that the AFR short-term loan rate published by the IRS is equivalent to market rate with respect to its intercompany loan because of the demand note nature of the loan. Additionally, CFC2 disputed the withholding rate of percent, referencing the Agreement, which CFC2 understood to mean that any future interest insufficiencies would be subject to a withholding rate of percent.

On , Taxpayer requested CA assistance regarding the amount of interest properly chargeable on the loan from CFC2 to USSub for the tax years at issue, with potential application to subsequent tax years. The CA petition outlined the terms of the final Foreign Tax Agency decision imposing withholding taxes on dividends deemed paid by CFC2 to USSub, representing the difference between the interest rate paid by USSub and the arms-length interest determined by the Foreign Tax Agency. The proposed withholding tax rate of percent is based on Foreign domestic law, though the CA request states that Foreign authorities have informally indicated that this rate of tax may be reduced, upon petition by Taxpayer, under the Treaty. In its CA request, Taxpayer argued that the short-term interest rate was an appropriate arms-length rate, given the demand nature of the loan in question; that the Foreign tax was imposed on “income” that does not exist for U.S. purposes in accordance with the IRC Section 482 regulations, because, as stated by Taxpayer, the “transfer pricing… was acknowledged to be at arm’s length from a U.S. perspective;” and, that, even if the tax were properly withheld on the constructive dividend, the percent withholding rate was inconsistent with the Treaty.

On , the Foreign Tax Agency issued its Decision on Appeal, in which it upheld its determination that the loan was long-term in nature, and, therefore, the interest rates it determined were consistent with that finding. Additionally, the Foreign Tax Agency confirmed the withholding rate of percent. In accordance with the Foreign Federal Withholding Tax Statute, the Foreign Tax Agency determined that CFC2 must pay a withholding tax of and pass the burden of the tax onto USSub, the entity receiving the constructive dividend. The Foreign Tax Agency explained that, in accordance with the Treaty, Foreign withholding tax on a dividend may not exceed percent when the shareholder is a company that directly or indirectly controls percent of the voting rights of the company paying a dividend and when not more than percent of the gross income of the company paying a dividend stems from interest or dividends other than those paid by its own subsidiaries. The Foreign Tax Agency noted that, while USSub controls CFC1 and CFC1 controls CFC2, USSub is not a “shareholder” which controls CFC2 directly or indirectly to the extent of more than percent. The Foreign Tax Agency claims the Foreign Federal Tribunal’s interpretation

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6 The increased interest that USSub is deemed to have paid by virtue of the adjustment is being treated by the Foreign Tax Agency as having been distributed to USSub and, therefore, is considered a constructive dividend.
of the relevant treaty provision is that USSub must hold at least a minority participation directly in CFC2 to be entitled to the beneficial rate. With respect to the percent withholding tax rate referenced in the Agreement, upon which CFC2 claims it relied, the Foreign Tax Agency found the reliance misplaced because the Agreement regarding interest payable by USSub to CFC2 anticipated that the interest rates would be in line with market. When such rates are determined not to be in line with the market rates, the consequences are outside the framework of the Agreement, which solidified an amicable solution, as opposed to a litigated one. On , CFC2 filed an appeal against this decision with the (“Appeals”).

On , the IRS notified Taxpayer of the CA proposed resolution to eliminate economic double taxation. The CA determined the arms-length interest rate on the loan to be percent, which reduced the total constructive dividend for the tax years at issue from , as originally determined by the Foreign Tax Agency, to . Additionally, the U.S. would provide correlative relief for this increase in CFC2’s income by allowing Taxpayer a corresponding interest deduction of USD . The U.S. and Foreign competent authorities further agreed that the Foreign withholding tax rate on the constructive dividend to USSub would be percent and that the U.S. would also apply a percent withholding tax on the additional interest deemed paid by USSub to CFC2. The CA Disposition Memo also stated that Taxpayer could claim a foreign tax deduction or credit for the Foreign withholding tax that was paid on the constructive dividend to the extent permitted by U.S. domestic law, as well as a deemed-paid credit for additional Foreign tax paid by CFC2 with respect to the subpart F income resulting from the additional interest income. The CA proposal was applicable to the tax years at issue and not binding in subsequent years.

On , Taxpayer withdrew its request for CA assistance based on its view that the terms of the CA agreement are unacceptable. Taxpayer objected to the proposed imposition of a U.S. withholding tax on the proposed adjustment amount, which was based on an interest rate for the intercompany loan that Taxpayer characterized as well in excess of the short-term rate, which Taxpayer claims the IRS exam team agreed was an arm’s-length rate under U.S. principles and law. By letter dated , the Service acknowledged Taxpayer’s withdrawal of its CA request and advised that, for purposes of Treasury Regulations Section 1.901-2(e)(5)(i), the rejection of the CA agreement does not demonstrate that Taxpayer has exhausted all effective and practical remedies to reduce its Foreign tax liabilities. Taxpayer maintains, but has not documented, that it sought and relied on advice from competent Foreign advisors and counsel with respect to pursuing its remedies in the Foreign

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7 This rate was based on an interest rate of percent, which CFC2 was being charged on another intercompany loan, plus percent. The U.S. CA agreed that the loan was long-term and that a long-term interest rate would reflect an “arm’s length” charge.

8 Both parties agreed that this is the correct rate for dividends under of the Treaty.
courts, based on the expectation of a greater reduction of USSub’s and CFC2’s Foreign tax liabilities. Taxpayer argued that the additional U.S. taxes that would have been imposed on CFC2 under the CA agreement should be included in the costs taken into account in determining whether continuing to pursue CA relief would have been an effective and practical remedy to minimize USSub’s and CFC2’s Foreign tax liability.

On [date], Taxpayer began filing protective claims preserving its right to file claims for refund or credit with respect to potential future payment of Foreign withholding taxes if the Foreign determination of additional interest income of CFC2 and a constructive dividend to USSub were upheld. The assessment statute expiration date (“ASED”) for each tax year had been extended under agreement pursuant to IRC 6511(c). Each of the protective claims was filed prior to six months from the applicable ASED, as reflected on IRS transcripts.

On [date], Appeals dismissed CFC2’s appeal dated [date] and upheld the determination and amount of the constructive dividend. It did not address the issue of levying the withholding tax at a reduced rate of [percent] percent, considering that that issue would be the object of a separate procedure. CFC2 responded to the dismissal by filing an appeal of that decision with the Foreign Supreme Court on [date]. In its petition, CFC2 requested that the Foreign Supreme Court find that CFC2 did not pay a constructive dividend to USSub; but if it determined that a constructive dividend was paid, then CFC2 also requested the withholding tax rate be immediately reduced to [percent] percent, given CFC2’s interest in the issue and the interests of procedural swiftness. CFC2 argued in its petition that it qualified for the withholding tax beneficial rate of [percent] because it met the three necessary conditions: 1) dividends are at stake; 2) the shareholder (USSub) is a company controlling, directly or indirectly, at least [percent] of the votes of the company paying the dividends (CFC2); and (3) the gross income of the company paying the dividends does not include over [percent] percent of interest or dividends other than those issued from its own subsidiaries. Although the term “shareholder” is not defined in the treaty, CFC2 argued that, if the treaty provides for a withholding tax reduction at source to the [percent] rate, even when [percent] percent of the casting votes are exercised only indirectly, then this provision must also apply to shareholders, even if their entire ownership is indirect.

On [date], Appeals filed its observations to the Foreign Supreme Court regarding CFC2’s petition before the Foreign Supreme Court. Appeals found the

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9 Additional taxes paid by CFC2 in respect of additional interest income would be eligible to be included in foreign taxes deemed paid only with respect to inclusions and dividends paid in and after the tax year in which the additional taxes were paid. IRC Section 905(c)(2)(B)(i)(I).
10 IRS transcripts for tax years through [year] reflect an ASED of [ASED]. Protective claims were filed for these tax years on [date], within six months of the expiration of the ASED. See IRC 6511(c). The ASED for tax year [year] is [ASED], and the protective claim for such year was filed on [date]. Both parties agree that the protective claims filed on [date] for tax years [year] through [year] are within the claim filing deadline of [date]. The claim filing deadline for tax year [year] is [date]. A timely refund claim for tax year [year] was filed on [date].
existence of a constructive dividend and collection of the withholding tax would be determined under the Foreign federal law as distinguished from the tax reimbursement procedure occurring at a later date. With respect to the withholding tax rate, Appeals maintained that, although initially the percent withholding tax rate issue was before it, in CFC2’s rejoinder dated , CFC2 agreed to delay the examination of the percent withholding tax rate to a future tax reimbursement procedure. Accordingly, because CFC2 had restricted its pleas to the sole issue of the existence of a constructive dividend, the issue of the withholding tax rate was not before the Foreign Supreme Court. Nevertheless, Appeals maintained that the proper withholding tax rate would be percent, the rate associated with constructive dividends under Foreign federal law. The debtor of the taxable provision, in this case CFC2, is obligated then to transfer the tax burden to its beneficiary, i.e., USSub, who, if located abroad, seeks relief, as appropriate, through the Treaty. Appeals explained that the relevant Treaty provision effectively institutes a simplified administration process by which the debtor directly pays the rate corresponding to the non-refundable portion of the withholding tax amount and the Treaty allows the beneficiary of the taxable provision subject to withholding tax to avoid having to request the reimbursement of the tax later on. Nevertheless, Appeals maintained that this administrative convenience is applicable only in a non-contentious context and not in a case where the underlying adjustment is being disputed.

On , the Foreign Supreme Court rendered its decision, limiting its review to claims and pleas that were the objects of the decision of the lower judiciary court. Accordingly, the Foreign Supreme Court did not consider the withholding tax rate as an issue before it. With respect to the interest rate on the loan from CFC2 to USSub, the Foreign Supreme Court determined that the loan was more appropriately characterized as long-term rather than short-term, given the fact that no payment had been made during the course of the litigation and the interest was capitalized by increasing the principal amount due. Such favorable loan terms, the Foreign Supreme Court concluded, would not have been granted to a third-party debtor; instead, the lender would have demanded interest based on the higher rates of long-term loans. Accordingly, the Foreign Supreme Court upheld the Foreign Tax Agency’s determination of the existence and amount of the constructive dividend and dismissed CFC2’s appeal.

From through , Taxpayer maintains that, in conjunction with CFC2, it continued to work with the Foreign authorities to resolve the issue of the proper interest rate on the loan between USSub and CFC2, as well as the proper withholding tax rate for all the relevant tax years – the tax years at issue in the Foreign court system, as well as the subsequent tax years from through . Taxpayer explained that, based on the decisions and references made to the withholding rate in the court filings, it understood that the only determination that it could have obtained by pursuing the withholding tax rate issue in the Foreign courts would have been one that required any reimbursement to be pursued subsequently by Taxpayer. Instead, it
pursued the matter as part of its negotiations with the Foreign Tax Agency in an effort to have CFC2 granted the immediate withholding tax rate benefit of percent.

On [ ], CFC2 and its foreign affiliated entities received determinations from the Foreign Tax Agency, outlining the final resolution of the disputed adjustments, reflecting the assessment of a percent withholding tax on the constructive dividend.\(^{11}\)

For the tax years at issue, the total withholding tax under the settlement is

\[(\text{percent on a constructive dividend of } \ldots)\]

as compared to the original withholding tax assessment by the Foreign Tax Agency of

\[(\text{percent on a constructive dividend of } \ldots)\].\(^{11}\)

On [ ], CFC2 and the remaining entities received notice from the Foreign Tax Agency acknowledging receipt of the withholding tax payment for the years through . Taxpayer reimbursed CFC2 in for the withholding tax payments and deducted the taxes on its tax return. Taxpayer intends to file an amended return for in which the deduction is reversed, if the Service grants the refund claims it filed based on claiming FTCs for the same taxes in the earlier years to which the taxes relate.

Taxpayer maintains that the initial Foreign proposed adjustment in [ ] for the tax years at issue was a constructive dividend of , subsequently reduced to a constructive dividend of , after additional documentation was given to the Foreign Tax Agency. Thirteen years later, and pursuant to numerous actions in the Foreign court system, including an appeal to the Foreign Supreme Court, Taxpayer and the Foreign Tax Agency settled the issue of the interest rate on the intercompany loan, as well as the withholding tax rate applied to the constructive dividend. Taxpayer’s settlement with the Foreign Tax Agency was based on an agreed constructive dividend of \(^{12}\) for the tax years at issue and further included the additional tax years through .\(^{13}\) The Foreign Tax Agency granted CFC2 the percent withholding rate on the constructive dividend for all the claim years. The end result for the tax years at issue is a higher total amount of interest income for CFC2 and constructive dividend to USSub than that based on the interest rate initially determined by the Foreign Tax Agency and upheld by the Foreign courts, but (due to allowance of the percent treaty rate) a much lower total withholding tax due than that originally determined by the Foreign Tax Agency and upheld by the courts.

\(^{11}\) Despite Exam’s repeated efforts to obtain copies of the terms of the negotiated settlement, Taxpayer maintains that the letters it received showing the withholding tax due are the only written documents that it has reflecting the settlement. The total constructive dividend for all the affiliated foreign entities for the tax years through is , of which is attributable to CFC2. The percent withholding tax for such years totals , of which is attributable to the constructive dividend paid by CFC2.

\(^{12}\) Taxpayer claims it does not know how the Foreign Tax Agency determined the interest rate for purposes of the final settlement. The end result for the tax years at issue is a higher total amount of interest income for CFC2 but a lower total withholding tax calculated at the treaty rate of percent versus the percent originally determined by the Foreign Tax Agency.

\(^{13}\) Taxpayer estimates that the expected savings arising out of its agreement with the Foreign Tax Agency, compared to the amounts due resulting from the Foreign court proceedings without benefit of the lower treaty rate, is .
The ultimate settlement resulted in tax paid in excess of the amount that would have been paid under the proposed CA settlement that was rejected by Taxpayer.

LEGAL ANALYSIS

Protective Claims

The taxpayer can file a claim for refund relating to an overpayment attributable to creditable foreign taxes paid or accrued at any time prior to the expiration of the period prescribed by IRC Section 6511(d)(3)(A) or IRC Section 6511(c), if the period is extended by agreement. Effective for foreign taxes paid or accrued in tax years beginning after August 5, 1997, IRC Section 6511(d)(3)(A) provides that if a claim for credit or refund relates to an overpayment attributable to any taxes paid or accrued to any foreign country for which credit is allowed against the tax imposed by subtitle A in accordance with the provisions of IRC Section 901 or the provisions of any treaty to which the United States is a party, in lieu of the 3-year period of limitations prescribed in subsection (a), the period shall be from the date prescribed by law for filing the return for the year in which such taxes were actually paid or accrued. For foreign taxes paid or accrued in earlier years, IRC Section 6511(d)(3)(A) provided that the period was determined with reference to the due date of the return “for the year with respect to which the claim is made.” The due date of the return is determined without regard to extensions. Treas. Reg. §301.6511(d)-3(a). Section 6511(c) provides that if an agreement pursuant to IRC Section 6501(c)(4) is executed, thereby extending the period for assessment, the period for filing a claim for credit or refund shall not expire prior to 6 months after the expiration of the period within which an assessment may be made pursuant to the extension agreement. In the case at hand, the ASEDs, as reflected on IRS transcripts, support Taxpayer’s position that the statutes were open to support claims for refund attributable to foreign taxes paid with respect to the tax years through at the time Taxpayer filed its protective claims.

In addition to being timely filed, protective claims must also contain sufficient information to apprise the Service of the basis for the credit or refund claims in accordance with Treasury Regulations Section 301.6402-2. This requirement is generally satisfied as long as the claim is sufficiently clear and definite to apprise the Service of the essential nature of the claims, even though it does not state facts sufficient to establish that the taxpayer is actually entitled to recover an overpayment. See GCM 38786, 1981 WL 169576. Thus, a valid protective claim need not state a particular dollar amount or demand an immediate refund, but it must be sufficient to put the Service on notice that a tax refund is sought, focus the Service’s attention on the merits of the claim, and identify the specific years for which a refund is sought. See United States v. Kales, 314 U.S. 186 (1941); IRM 25.6.1.10.2.6.5(2) (5-17-2004). In this case, Taxpayer filed Forms 1120X for each of the tax years through , excepting , with an attachment explaining the filings as protective claims and providing the basis for the claim, that is, that Taxpayer appealed the Foreign Tax Agency decision, in which it assessed Foreign withholding tax on constructive dividends from CFC2 to USSub; the
Foreign Supreme Court issued a decision addressing the amount of loan interest that Taxpayer should have paid under Foreign law; and Taxpayer is working with Foreign authorities to determine the Foreign tax that may be due under the decision and for other taxable years. Taxpayer’s filed Forms 1120X are procedurally valid protective claims.

On -----------------, Taxpayer perfected the protective claims by filing Forms 1120X for the tax years -------- through -------- and -------- through -------, reflecting the FTCs as determined pursuant to the final agreement with the Foreign Tax Agency with respect to the withholding taxes on the constructive dividends for tax years -------- through -------.14

Amount of Creditable Tax Paid (Exhaustion of Remedies/Compulsory Payment Requirement)

U.S. corporations are generally taxed on worldwide income. This subjects the entity to double taxation when income earned abroad is taxed by both the United States and the foreign country in which the income is earned. To alleviate the double taxation, IRC Section 901(a) allows the taxpayer a credit for foreign income taxes paid or accrued, thereby reducing the taxpayer’s U.S. tax liability by the amount of taxes paid to the foreign country, such that the total amount of tax paid to all countries is the same amount of tax that would have resulted if the income had been subject to tax only once at the U.S. corporate rate. Subject to the limitation of IRC Section 904, IRC Section 901(b)(1) allows citizens and domestic corporations a foreign tax credit in the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country.

Treasury Regulations Section 1.901-2 sets forth the requirements that must be met in order to determine whether a foreign levy is a tax such that a taxpayer can claim a foreign tax credit for payment made to a foreign country. A foreign levy is a tax if it requires a compulsory payment pursuant to the authority of a foreign country to levy taxes. Treas. Reg. § 1.901-2(a)(2)(i). An amount paid is not a compulsory payment to the extent that it exceeds the amount of liability under foreign law for tax. Treas. Reg. § 1.901-2(e)(5)(i). Treasury Regulations Section 1.901-2(e)(5)(i) further provides:

An amount paid does not exceed the amount of such liability if the amount paid is determined by the taxpayer in a manner that is consistent with a reasonable interpretation and application of the substantive and procedural provisions of foreign law (including applicable tax treaties) in such a way as to reduce, over time, the taxpayer’s reasonably expected liability under foreign law for tax, and if the taxpayer exhausts all effective and practical remedies, including invocation of competent authority procedures available under applicable tax treaties, to

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14 Taxpayer filed Form 1120X for tax year -------- as well, for which the claim filing deadline had been extended to .

15 Taxpayer did not file claims for tax years -------- through -------, electing instead to take a deduction for withholding taxes paid in tax year -------- with respect to those years.
reduce, over time, the taxpayer's liability for foreign tax (including liability pursuant to a foreign tax audit adjustment).

With respect to the interpretation of foreign law, the regulations allow the taxpayer to rely on advice from foreign tax advisors. See id. Remedies pursued by the taxpayer are considered effective and practical only if the associated costs, including the risk of offsetting or additional foreign tax liability, are reasonable, taking into account the amount at issue and the likelihood of success. Id.

In this case, Taxpayer sought CA assistance regarding the audit adjustment proposed by the Foreign Tax Agency with respect to both the determination of additional interest income to CFC2 and a constructive dividend to USSub and, in the event such determination was upheld, the applicable withholding tax rate on the dividend. Taxpayer withdrew its request for CA assistance, objecting to the proposed settlement terms that included an additional U.S. withholding tax due from CFC2 on the additional interest income due from USSub to CFC2. In response to an Information Document Request, Taxpayer stated that, “The additional U.S. taxes proposed by CA were an ‘additional tax liability’ that added to [Taxpayer]’s costs and when taken into account at the relevant time made the CA proposal a remedy that was not effective and practical pursuant to Treas. Reg. 1.901-2(e)(5).”

Taxpayer had separate obligations to minimize USSub’s Foreign withholding tax imposed on the constructive dividend and CFC2’s liability for Foreign net income taxes imposed on its interest income. The U.S. withholding tax that would have been imposed on CFC2 as part of the CA settlement is not properly considered a cost of minimizing CFC2’s Foreign tax liability. It would completely undermine the purpose of the noncompulsory payment rules to consider correlative adjustments of U.S. tax to be costs of obtaining a reduction of foreign tax that can justify not pursuing an effective and practical remedy, because the anticipated consequence of any reduction in foreign tax and associated FTCs is generally an increase in U.S. tax. In any event, in this case CFC2’s U.S. withholding tax would decrease, not increase, with any reduction of CFC2’s Foreign net income tax liability as part of a bilateral CA agreement. Moreover, U.S. withholding tax imposed on CFC2 is not a cost of minimizing Foreign withholding tax imposed on USSub, a separate taxpayer.16 Accordingly, collateral U.S. tax consequences of settling its Foreign tax dispute are not properly taken into account as costs of pursuing any avenue of relief available to Taxpayer. Rather, the

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16 Notice 2007-95, 2007-49 I.R.B. 1091, permits taxpayers to rely on 2007 proposed amendments to Treas. Reg. section 1.901-2(e)(5)(iii) and (iv) that would treat as a single taxpayer all foreign entities in a U.S.-owned foreign group. Thus, the proposed regulations would allow taxpayers to consider all members in a chain of CFCs as a single taxpayer in applying the obligation to minimize the creditable foreign taxes paid by the group members that are eligible to be deemed paid under IRC section 902. However, the proposed regulations do not include U.S. shareholders in the definition of a U.S.-owned foreign group. Further, the notice is only effective for tax years ending on or after March 29, 2007. Therefore, Notice 2007-95 and the 2007 proposed regulations are inapplicable to the case at hand.
reasonableness of Taxpayer’s settlement must be evaluated based on the potential benefits, risks and non-U.S.-tax costs of continuing to contest the Foreign adjustments.

Revenue Procedure 2006-54 provides that the fact that a taxpayer who seeks CA assistance but obtains no relief because the taxpayer rejects an agreement reached by the CA generally will not, in and of itself, demonstrate that it has exhausted all effective and practical remedies to reduce its foreign tax liability. Therefore, Taxpayer is required to demonstrate that it rejected the CA settlement to pursue other administrative and litigation remedies because it reasonably believed resort to the Foreign administrative process and courts could achieve a greater reduction in its Foreign tax liability.

In maintaining that it thought it could achieve a better result in the Foreign court system than that proposed by the CA, Taxpayer claims that it relied on the advice of foreign tax advisors. Although it has not produced any written opinions of such advisors, upon rejecting the CA proposal Taxpayer appealed the Foreign Tax Agency’s determination with respect to the interest rate to Appeals and eventually the Foreign Supreme Court. Although the proposed CA settlement was based on a smaller amount of constructive dividend than it ultimately obtained through its litigation and settlement with the Foreign Tax Agency, the exhaustion of remedies requirement is based on reasonable expectations at the time the avenue of relief is foregone, not hindsight. Given that Taxpayer pursued its claim to reduce the interest rate through Foreign appellate proceedings through to the Foreign Supreme Court, it is reasonable to infer that Taxpayer believed it could achieve a lower interest rate than that offered in the CA settlement by litigating the interest rate issue in the Foreign courts. In our view, in light of Taxpayer’s subsequent prosecution of the contest a court would likely determine that its rejection of the CA settlement proposal to pursue local Foreign law remedies did not constitute a failure to exhaust its effective and practical remedies to minimize its Foreign tax liability.

In addition, although the Foreign courts upheld a higher interest rate than the IRS determined constituted an arms-length rate under U.S. tax principles, the relevant standard in determining whether the Foreign tax paid was compulsory is whether that determination was consistent with a reasonable application of Foreign tax law as modified by the Treaty, not whether the result is consistent with the appropriate result under U.S. tax law. See Schering Corp. and Subs v. Comm’r, 69 T.C. 579 (1978) (holding the withholding taxes assessed on a dividend paid to Schering by its foreign CFC were compulsory taxes under IRC Section 901, even though the amount repatriated did not constitute a dividend for U.S. tax purposes);

Taxpayer’s litigation of the interest rate dispute through the Foreign Supreme Court exhausted its Foreign law remedies with respect to the interest rate charged on the loan
from CFC2 to USSub, but not with respect to the applicable withholding tax rate, which the Foreign courts did not address. As discussed above, the Foreign Tax Agency’s position with respect to the applicable withholding tax rate was based on its interpretation of the definition of a shareholder to include a direct ownership requirement. Although CFC2’s petition to the Foreign Supreme Court addressed the issue of the withholding tax rate, the Court did not rule on it because, as stated in Appeals’ observations to the Court, that matter was not properly before the Court. Nevertheless, Appeals opined that it was not for the Foreign courts to decide whether USSub was entitled to the beneficial withholding tax rate under the Treaty; rather, CFC2 was required to withhold at the percent rate and Taxpayer was required to pursue any refund for a withholding rate differential applicable under the Treaty. Because Taxpayer secured the benefit of the percent Treaty rate in its eventual settlement with the Foreign Tax Agency, in our view Taxpayer also exhausted its effective and practical remedies to reduce the applicable Foreign withholding tax rate.

Taxpayer’s acceptance of a higher interest rate than that affirmed by the Foreign courts, in connection with a favorable settlement of the Treaty rate issue for the tax years at issue and for subsequent years with the Foreign Tax Agency, should be evaluated based on an assessment of the hazards under Foreign law with respect to the availability of the percent Treaty rate. Taxpayer asserted that there was a substantial risk that had it not agreed to the higher interest rate, it would not have obtained the benefit of the percent rate or extended the settlement terms to later years. Taxpayer also maintains that it was advised by its Foreign tax counsel to accept the settlement eventually proposed by the Foreign Tax Agency, characterizing it as very favorable, considering the expenses incurred to date and the fact that the settlement offer covered thirteen subsequent tax years as well as the tax years at issue. However, Taxpayer has not produced an analysis of Foreign law or an opinion of its tax advisors in support of its position.

Taxpayer claims that it relied on advice obtained in good faith from foreign tax advisors to whom it disclosed relevant facts. Treas. Reg. Section 1.901-2(e)(5) provides that a remedy is effective and practical only if the cost thereof (including the risk of offsetting or additional tax liability) is reasonable in light of the amount at issue and the likelihood of success. In order to meet the requirements of the regulation, the advice of foreign counsel must analyze the likelihood and projected cost of Taxpayer achieving a further reduction in its Foreign tax liability by rejecting the Foreign Tax Authority’s proposed settlement and pursuing further administrative or judicial proceedings. See Schering Corp & Subs. v. Comm’r, 69 T.C. 579 (1978) (a taxpayer is not required to take futile administrative steps); Proctor & Gamble v. United States, No.1:08-cv-00608 (S.D. Ohio 2010) (holding that tax paid to Korea was compulsory under Treasury Regulations Section 1.901-2(e)(5) where taxpayer did not appeal tax paid nor did it seek CA relief based on the advice of a Korean law firm that those steps would be futile). In making this determination, the costs to be taken into account are those incurred in seeking to reduce the taxpayer’s foreign tax liability and do not include collateral U.S. tax
consequences, such as additional U.S. withholding taxes on CFC2’s imputed interest income.

Case Development/Litigation Hazards –
This writing may contain privileged information. Any unauthorized disclosure may undermine our ability to protect the privileged information. If you determine disclosure is necessary, please contact the undersigned.

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